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Statement by

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Mr. Chairman, I am pleased to appear on behalf of the Board of Governors of the Federal Reserve System to address issues related to consumer credit. I will focus my prepared remarks on the questions you raised in your letter of invitation.

Let me begin with some background. Two months ago, the United States economy entered the fourth year of its current expansion. While this expansion began on a sluggish note, economic growth has been appreciable, on average, since early 1992. For example, real gross domestic product (GDP) expanded 3.9 percent during 1992 and 3.1 percent during 1993. During the first quarter of this year it rose at an annual rate of 3.0 percent, in line with the expectations of growth for this year given in February by the members of the Federal Open Market Committee (FOMC).

This economic expansion has resulted in moderate, but still healthy, job gains and falling unemployment. We can all be pleased with the decline in the unemployment rate to 6.0 percent in the latest survey by the Bureau of Labor Statistics.

As is usually the case, changing spending patterns in the household sector have been key to the expansion. For example, in inflation adjusted terms, the increase in personal consumption expenditures has amounted to 71 percent of the expansion in Gross Domestic Product since the recovery began in the second quarter of 1991. If anything, the importance of consumption has increased as the recovery progressed. Since the first quarter of

1993, increased consumption has accounted for 77 percent of the expansion in overall GDP. By contrast, during the economic expansion from 1982 to 1990, consumption growth was responsible for just 68 percent of the growth in GDP.

Investment in residential real estate showed a similar trend. During the current expansion, housing has accounted for 16.4 percent of the growth in GDP. During the 1980s expansion, increases in housing represented only 6.2 percent of the increase in GDP. Combining these two categories of household outlays, therefore, shows the importance of the household in the current expansion. The growth in personal consumption and housing investment constituted 87 percent of GDP growth since the expansion began, compared with 74 percent during the 1980s. Thus, the questions you asked, Mr. Chairman, about the financial health of the household sector and its continued access to credit are particularly pertinent in today's economic environment.

As is usually the case in economic expansions, higher levels of household debt have helped finance increased activity. As policy makers, we should recognize that households are the best judges of their own financial circumstances, so we should not view these increased levels of debt as necessarily "good" or "bad". Increased levels of household income, more optimistic attitudes toward employment prospects, and generally favorable conditions for borrowing are all contributing to the recently increased willingness of households to take on debt.

The first question in your letter asked about recent growth in consumer credit and how it compares with past expansions. It is important to consider the various types of consumer credit. The Federal Reserve has just released its report on consumer installment credit. In April, installment credit grew at an 13.2 percent annual rate, following a revised 12.6 percent rate in March, slightly higher than the 11.2 percent growth during the fourth quarter of last year. It is certainly well above the full-year growth of 6-1/2 percent in 1993 or growth in 1992 of just 1 percent. Indeed, the double-digit pace reached over the past half year or so is the most rapid since the third quarter of 1986.

Nevertheless, it is hard to determine conclusively how the current rate of credit expansion compares to historical norms. Recall that we are now in the fourth year of an economic upswing. As the above data indicate, installment credit growth was quite subdued during the early portions of the current expansion. This makes qualitative comparisons of current growth with that in comparable earlier time periods somewhat problematic. The resurgence in consumer installment credit has come later than usual in the current economic expansion, and the recent pace has still been well below peak rates reached during some earlier expansion periods.

Typically, installment credit starts to climb in the first or second quarter of a recovery, and is generally rising quite sharply by the second year, often reaching growth rates of 15 to 20 percent at some point in the cycle. In contrast, during the most recent upturn in the economy, installment credit continued to contract through the fifth quarter of recovery; its growth rate did not reach double digits until October of 1993, two and one half years into the recovery. On the other hand, the household sector entered this expansion with a higher level of debt than it had in the past, making comparison of percent increases difficult.

We should bear in mind that swings in consumer credit growth are wider than fluctuations in the economy as a whole because consumer credit is used most heavily to finance purchases of durable goods, which are much more cyclical than consumer income or total consumption. Durable goods include autos and large consumer appliances, which often move with home sales. The strength in these two sectors has meant that durables have been particularly important in the present expansion contributing to 25 percent of increased GDP, compared with just 16 percent during the 1980s' expansion.

The comparability of the data on credit growth is also somewhat limited by the development of alternative means of finance. Changes in consumer tastes, the marketing of financing alternatives, and the tax environment all can affect the composition of consumer credit. For instance, the phasing out of tax deductibility of interest payments on non-mortgage consumer loans after 1986 has prompted some shift towards more use of home equity credit and less of traditional consumer loans. The tailoring and promotion of auto leasing to individual consumers has provided them with another means of acquiring cars that has considerable appeal for some types of consumers. I would not want to overstate the impact of these alternatives -- estimates made by the Board staff indicate that shifts to these forms of financing have trimmed from one to three percentage points off the growth rate of consumer installment credit in recent years -- but such considerations do muddy the comparisons a bit.

A similar type of credit product change which makes comparison across business cycles difficult has been the development and spread of general purpose credit cards for individual consumers during the past few decades. From less than $10 billion in 1970, debt outstanding on bank credit cards has grown to more than $200 billion today. Revolving credit, including retail store cards as well as bank cards, is now the largest component of consumer credit, recently surpassing auto credit.

How this development affects consumer balance sheets is somewhat unclear. A considerable amount of this revolving credit is commonly called "convenience credit" because it is repaid by consumers within an interest-free grace period. Whether one should view convenience credit as debt in a true sense is open to question, but to the extent that convenience credit is on a creditor's books on the last day of the month, it will be included in our measure of consumer credit. The contribution of convenience use to credit growth takes on more importance these days as people run more expenditures through their cards to rack up frequent flier mileage or points toward purchase of an automobile. Overall credit market conditions also affect the consumer's choice of debt and makes historical comparison problematic. For example, efforts to trim debt during the early 1990s and the early part of this expansion were probably reinforced by historically wide spreads between interest rates consumers were paying on existing loans and the interest rates they could earn on new financial assets. In response to these wide spreads, some people elected to pay down debts with maturing assets rather than roll them over at extremely low yields. For example, a consumer with a maturing certificate of deposit yielding 8 percent might choose to pay off a 10 percent car loan with the funds when new certificates of deposit yield only 3 or 4 percent. In essence, these spreads represent the cost of household liquidity, and households elected to assume less liquid positions, reducing levels of both debt and of financial asset holdings as a result of this increased cost. Again, the lack of comparability of these developments with other business cycles makes an evaluation of consumer debt positions difficult.

In sum, these factors seem to have come together in recent months. The pattern of durable goods consumption has turned stronger, providing a stimulus to the growth of installment credit. Healthier consumer balance sheets, resulting from both the earlier slowdown in growth of mortgage and consumer debt and substantially lower average interest rates on the stock of debt, have probably made individuals feel more comfortable about taking on debt again. In addition, heavy promotion of credit cards with rebates and other incentives tied to the volume of transactions has apparently boosted growth in this area.

As I have indicated, comparisons of growth rates over time are complicated. Sifting through all these considerations, I think it is fair to say that the strength in consumer credit seen so far is not out of line with historical patterns. We also need to look at the ability of households to support the debt. The stock of mortgage and consumer debt relative to income is historically high, and has begun to rise a bit with the recent rebound in debt growth after it had leveled off for several quarters.

On the other hand, debt-servicing payments -- covering both interest and principal -- relative to income suggest a net decline in burden. Our staff's estimate of the share of disposable income allocated to scheduled principal and interest payments by the end of last year had fallen appreciably from the beginning of the decade. This decline resulted from the slowdown in borrowing as well as to lower borrowing costs, especially those resulting from the surge in mortgage refinancing that accompanied declines in mortgage rates to historically low levels. More recently, as household debt growth has strengthened and interest rates have turned up, debt service payments perhaps have edged up.

The prospective risks this might pose are probably best determined by direct measures of debt payment performance. In this regard, delinquency rates on consumer and mortgage loans have suggested for some months now that the risks associated with debt burdens have diminished. According to both industry data from the American Bankers Association and calculations from bank call reports, consumer loan delinquencies have been on the downswing since at least early 1992.

The ABA series for all loans combined dropped in the fourth quarter last year to its lowest level since the first quarter of 1984. Similar evidence is provided by data on past-due auto loans at the auto finance companies and on past-due home mortgages reported by the Mortgage Bankers Association. Personal bankruptcies, although still historically quite high, have also been declining in recent months.

Nonetheless, looking below these aggregate statistics, there are reasons to believe that some households have not made much progress in relieving debt burdens. As I have remarked elsewhere, there is some evidence to suggest that middle income households, who carry the bulk of household debt, may not have shared fully in recent income growth and thus in the improvement in aggregate debt-servicing burden.

Your second question dealt with the availability and affordability of consumer credit. Availability of credit -- the relative willingness of creditors to make loans to consumers at specified interest rates -- has increased. For instance, responses to the Federal Reserve's Senior Loan Officer Opinion Survey indicate that banks have become progressively more willing to lend to consumers since shortly after the end of the recession in 1991. Major new credit card plans have been offered within the past two years, such as the joint ventures between card issuers and the major auto manufacturers.

Many factors can affect the availability of consumer credit. Earlier in the decade, the balance sheet strains experienced by financial institutions resulting from heavy recession-related loan losses and the need to meet stricter capital requirements restrained the availability of consumer credit, just as they limited the supply of other types of credit. The profitability of consumer lending remained relatively attractive, however, and this type of lending was probably curtailed less than some other types, such as commercial real estate.

The development in recent years of a secondary market for consumer loans through securitization of auto loan and credit card receivables has also been a net plus for credit availability to consumers. Securitization has enabled banks and other traditional lenders to households, such as auto finance companies, to continue to originate consumer loans even when they were unable to profitably fund these credits themselves. This has brought new lenders into the market as indirect suppliers of credit, reducing the vulnerability of this source of credit to the occasional difficulties of traditional lenders.

An important component of the affordability of consumer credit is the interest rate charged on consumer loans. As you know, these rates have come down substantially. Auto loan rates at banks averaged about 11 percent in 1991, but had dropped to 7-1/2 percent on average by the first quarter of this year. This rate is dramatically lower than it has been historically. The previous record low was 10 percent, and occurred in 1972, the year the series was begun. As a result, the affordability of automobiles is at an historical high. Or put another way, debt payments on a new car relative to income are historically low.

With regard to revolving credit, our series on credit card rates, which typically has shown very little movement, dropped 2 percentage points from its recent high in early 1991. However, our credit card series may not fully take into account the increased variety of terms that have emerged in this area. Market segmentation has significantly complicated the analysis of effective credit card rates. In all likelihood, the reduction in effective rates to credit card holders is greater than our survey would suggest.

The third question in your letter requires us to look ahead. In my judgment, prospects for the availability and affordability of consumer credit are likely to remain quite favorable. Earlier this year, members of the Federal Open Market Committee anticipated further solid gains in output and income in 1994, in the neighborhood of 3 percent or so, a view that appears to have been confirmed by the evidence to date. Also, private forecasters continue to expect growth of around 3 percent this year. In this context of continued economic expansion, and given the stronger position of banks and other lenders, mortgage and consumer credit should generally be in ample supply. This situation will be buttressed by the continued development of active markets for securitized mortgages and consumer receivables.

The final question in your letter of invitation raised questions about interest rates on consumer deposits and whether they are unusually low in relation to market rates by historical standards. It is important to note that historical comparisons of deposit rates can be tricky, in part because retail deposit rates were subject to interest rate ceilings prior to the 1980s. Financial market deregulation and innovations during the 1980s have clearly brought tremendous gains to savers, particularly those who rely on typical consumer accounts.

It should be kept in mind that rate spreads have been affected by greater regulatory costs imposed on banks and thrifts in recent years, notably higher deposit insurance premiums. Still, the evidence shows that rates on NOW accounts, savings deposits, and money market deposits have been very sticky. They have been especially slow to respond to upward movements in market interest rates, although they have also been sluggish in the downward direction. In 1991 and 1992, when market rates of interest were coming down, rates on these accounts dropped less rapidly, making them quite attractive in relation to market instruments, such as Treasury bills. Rates on these bank deposit accounts continued to fall last year as they completed the adjustment to the earlier declines in market rates. By contrast, these rates currently appear to be sticky in an upward direction.

In part, this stickiness may reflect costs associated with changing such deposit rates. These costs may be both internal administrative and market based. Holders of these accounts seem to expect stability in rates and are prone to close accounts and move balances elsewhere when deposit rates are cut. In recent years, when market rates declined to the historically low levels, bankers appeared reluctant to drop rates on these liquid deposits and disturb their long term depositors in these accounts. During earlier rising rate environments, rates on such accounts lagged earlier upward movements in market rates. Banks and thrifts had been unwilling to raise rates on these accounts as costs would have risen for all accounts, not just new ones. Taking this historical pattern of stickiness into account, rates on these types of deposits do not appear to be noticeably out of line with previous experience.

In the case of retail CDs, rates have typically adjusted quite promptly to movements in market interest rates. Unlike the liquid accounts just discussed, adjusting the rate on such time deposits in keeping with movements in market rates does not immediately affect the whole cost structure of time deposits, only the cost of new deposits and roll-overs. Rates on retail CDs, nonetheless, appear to have been on the low side of historical norms over the past year or so perhaps in part because loan demand had been rather weak. In recent months, though, loan demand has firmed and rates on retail CDs have been rising steadily as banks have needed to raise funds.

In conclusion, Mr. Chairman, the recent strengthening in consumer credit can be viewed as another piece of evidence that the economic expansion is firmly in place. Credit to households appears to be quite readily available and many households, having completed substantial adjustments to alleviate debt-servicing strains, are showing that they are again willing to borrow to finance spending. Moreover, changes in our financial system, notably the securitization of mortgage and consumer debt, will better ensure that credit supplies are not disrupted by the financial difficulties of any segment of the financial services industry. I would be happy to answer any questions you might have.